

Office of Chief Counsel
Internal Revenue Service
memorandum

CC: [REDACTED]:TL-N-1315-99

VIA TELEFAX

ID# [REDACTED]

date: APR 9 1999

to: Chief, Examination Division, [REDACTED] District
Attention: Revenue Agent [REDACTED]

from: District Counsel, [REDACTED] District, [REDACTED]

subject: [REDACTED]
Deductibility of interest on a contested liability

DISCLOSURE STATEMENT

This advice constitutes return information subject to I.R.C. § 6103. This advice contains confidential information subject to attorney-client and deliberative process privileges and if prepared in contemplation of litigation, subject to the attorney work product privilege. Accordingly, the Examination or Appeals recipient of this document may provide it only to those persons whose official tax administration duties with respect to this case require such disclosure. In no event may this document be provided to Examination, Appeals, or other persons beyond those specifically indicated in this statement. This advice may not be disclosed to taxpayers or their representatives.

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ISSUE:

1. Whether the taxpayer can deduct accrued but unpaid interest in [REDACTED] when the litigation was not yet concluded?

CONCLUSIONS:

1. The taxpayer cannot deduct accrued but unpaid interest in [REDACTED] when the litigation was not yet concluded.

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FACTS AND DISCUSSION

[REDACTED] was involved in litigation over a nursing home that it managed in [REDACTED]. Suit was filed in [REDACTED]. [REDACTED] lost the litigation at the trial level in [REDACTED] and a \$ [REDACTED] judgement was imposed against it. The state intermediate appellate and supreme courts affirmed the judgement in [REDACTED].¹ The United States Supreme Court denied certiorari in [REDACTED]. The judgement against [REDACTED] was for \$ [REDACTED] for breach of contract; \$ [REDACTED] each for actual and exemplary damages; and (3) \$ [REDACTED] in prejudgement interest. The state intermediate appellate court reversed the portion of the judgement dealing with prejudgement interest on the basis that it was computed incorrectly under state law. That portion of the judgement was remanded to the trial court for further proceedings. Trial on this issue was scheduled for [REDACTED]. The entire case was settled on [REDACTED]. [REDACTED] accrued and deducted an interest expense of \$ [REDACTED] on its [REDACTED] income tax return. It appears that actual interest paid was \$ [REDACTED] the difference between the amount paid of \$ [REDACTED] and the compensatory and exemplary damages of \$ [REDACTED].

Under the all-events test, an accrual basis taxpayer can claim deductions only when all events necessary to establish the liability and fix the amount have occurred. Treas. Reg. §§ 1.446-1(c)(1)(ii), 1.461-1(a)(2). Where the liability is contingent and contested by the taxpayer, a deduction is allowable only when the litigation has been finally adjudicated. Commissioner v. Fifth Ave. Coach Lines, Inc., 281 f.2d 556 (2d Cir. 1960); Fox v. Commissioner, 874 F.2d 560 (8th Cir. 1989). In making the determination as to when the litigation has been finally adjudicated, the court will consider whether waiver of appeal rights or other exceptional situations justifying accrual prior to termination of the right to appeal exist. Id.

We agree with the analysis in the issue write-up, whereby you conclude that interest is not deductible since the litigation was not finally adjudicated until certiorari was denied by the United States Supreme Court in [REDACTED]. Even were the taxpayer able to bifurcate the proceeding into liability and interest components and argue that the interest component was not subject to the Supreme Court review, but was finally adjudicated when the trial court was reversed in [REDACTED], the amount was not fixed until [REDACTED]. Indeed, the state appellate court remanded the interest component and trial was

¹ The deductibility of funds transferred into an escrow arrangement under I.R.C. § 461(f) are the subject of a separate opinion.

scheduled for [REDACTED]. Consequently, we agree that neither the liability nor the amount were finally adjudicated nor fixed until [REDACTED].

We understand that since the Internal Revenue Service is not yet examining [REDACTED], it is unknown if the difference between the interest accrued and that actually paid was taken into income in the year in which it was paid. We suggest that you determine the extent that the interest deduction was claimed and/or should be allowed in [REDACTED]. To the extent that the taxpayer does not agree to timing and amount of the [REDACTED] and [REDACTED] interest adjustments, then you may want to take inconsistent positions by disallowing the interest deduction in [REDACTED] and including in income in [REDACTED] the difference between interest accrued in [REDACTED] and paid in [REDACTED].

Please contact the undersigned at [REDACTED] if you have any questions. We are closing our file subject to reopening if additional assistance on this issue is necessary.

Attached is a client survey which we request that you consider completing. The client survey is an attempt to measure your satisfaction with the service provided by this office. We expect to be able to use your response to improve the services that we provide to you.

By: [REDACTED]

Senior Attorney

cc: [REDACTED]

cc: [REDACTED] (via e-mail)

Cc: [REDACTED]